Summary of Testimony of
Curt L. Hébert, Jr.
Chairman, Federal Energy Regulatory Commission
Before the Committee on Energy and Natural Resources
United States Senate
March 15, 2001

Wholesale and retail electricity markets in California and throughout much of the West are in a state of stress. Wholesale prices have increased substantially for a variety of reasons, consumers are constantly implored to conserve as much as possible, and utilities are facing growing financial problems. As a result, many now argue that we need to return to cost-based regulation, instead of relying on market-driven solutions.

First, price caps are not a long-term solution. We need to promote new supply and load reductions. Market prices are sending the right signals to both sellers and buyers (at least those not subject to a rate freeze). Market prices will increase supply and reduce demand, thus correcting the current imbalance. Lowering prices through regulation or legislation will have exactly the opposite effect.

Second, infrastructure improvements are greatly needed throughout the West and especially in California. We need to create the appropriate financial incentives to ensure that new generation is built, that the transmission system is upgraded and that new gas pipelines are built.

Finally, we need a regional transmission organization (RTO) for the West. A West-wide RTO will increase market efficiency and trading opportunities for buyers and sellers throughout the West.

Consistent with these three points, the Federal Energy Regulatory Commission has been aggressively identifying and implementing market-driven solutions to the problems: (1) by stabilizing wholesale energy markets; (2) by identifying additional short-term and long-term measures that will increase supply and delivery infrastructure, as well as decrease demand; (3) by promoting the development of a West-wide regional transmission organization; and, (4) by monitoring market prices and market conditions.

Other regions that have not adopted California-type restrictions on electricity competition have demonstrated that consumers can and do gain from electricity competition and restructuring. California and Western consumers similarly can share in these gains, once market rules are in place that will make California and other Western states an attractive place for investment.

Testimony of
Curt L. Hébert, Jr.
Chairman, Federal Energy Regulatory Commission
Before the Committee on Energy and Natural Resources
United States Senate
March 15, 2001

I. Overview

Mr. Chairman and Members of the Committee:

Thank you for the opportunity to appear here today to discuss the topic of Western energy markets and possible legislative reform. Wholesale and retail electricity markets in California and throughout much of the West are in a state of stress. Wholesale prices for electricity have increased substantially for a variety of reasons in the last year. California power consumers face near-daily pleas to conserve. California load-serving utilities are under severe financial stress. Companies supplying wholesale power into California are unsure how much, or even whether, they will be paid for their supplies.

While the situation in California is not representative of other parts of the country that are successfully developing competitive markets, it nevertheless underscores the fundamental infrastructure problems facing the country. The demand for electricity continues to expand while supply fails to keep pace. The development and licensing of new hydroelectric capacity – which provides much of the existing power supply in the West – is nearly exhausted. Very little fossil-fired generation has been added in many regions of the country over the last few years, and in California no major plants have been added in the last decade. And the existing electric transmission grid is often fully loaded and, absent necessary expansion, is often incapable of delivering power to those regions where it is valued the most.

I would like to make three main points with respect to these problems and to identify the steps the Commission is taking to address these problems.

First, price caps are not a long-term solution. We need to promote new supply and load reductions. Market prices are sending the right signals to both sellers and buyers (at least those not subject to a rate freeze). Market prices will increase supply and reduce demand, thus correcting the current imbalance. Lowering prices artificially will have exactly the opposite effect.

Second, infrastructure improvements are greatly needed throughout the West and especially in California. We need to create the appropriate financial incentives to ensure that new generation is built, that the transmission system is upgraded and that new gas pipelines are built.

Finally, we need a regional transmission organization (RTO) for the West. California is not an island. It depends on generation from outside the State. The shortages and the prices in California have affected the supply and prices in the rest of the West. The Western transmission system is an integrated grid, and buyers and sellers need non-discriminatory access to all transmission facilities in the West. A West-wide RTO will increase market efficiency and trading opportunities for buyers and sellers throughout the West.

Consistent with these three points, the Commission continues aggressively to identify and implement solutions to the problems:

> **First**, in recent months, the Commission has issued a number of orders intended to restore market stability. The Commission has acted to move utilities out of volatile spot markets to enable them to develop a portfolio of risk reducing and creditworthy contracts.
>
> **Second**, my fellow Commissioners and I are working to identify and adopt additional measures that will increase supply and delivery infrastructure, as well as reduce demand for electricity in the Western Interconnection.
>
> **Third**, the Commission is continuing to work with market participants on developing, as quickly as possible, a West-wide regional transmission organization. Such an organization will bring a regional perspective and offer regional solutions to regional problems.
>
> **Fourth**, the Commission is monitoring market prices and market conditions with the goal of ensuring long-term confidence in Western markets. Moreover, the Commission's staff has proposed a new plan to monitor and, when appropriate, mitigate the price of electric energy sold in California's spot markets on a before-the-fact basis, instead of addressing prices through after-the-fact refunds. The Commission intends to act on this proposal by May 1, 2001.

By itself, however, the Commission can contribute only a small part of the solution to today's energy problems. A more comprehensive and permanent solution requires the involvement of the states and other federal agencies and departments. I am encouraged by all of the hard work and effort undertaken in recent months by the State of California and other Western states. The issues are difficult and the stakes are high. While reasonable minds can differ over the appropriate solutions to these problems, the Commission is committed to resolving these problems deliberatively.

An attachment to my testimony provides an analysis by Commission staff of the specific provisions of pending bills (S.26, S.80, S.287, and amendment No.12 to S.287) that are the focus of today's hearing.

II. How Did We Get Into This Situation?

A. Legislative Design

The State of California has been widely questioned for its restructuring legislation (A.B. 1890), enacted in 1996. While mistakes were made, California is to be commended for realizing that consumers are better off if supply and pricing decisions are based on market mechanisms, not bureaucratic fiat. The premise of this legislation is that consumers will enjoy lower rates and increased service options, without compromising reliability of service, if electricity providers are motivated to serve by market forces and competitive opportunities.

There were two major flaws in California's market design. First, the three utilities were forced to divest almost half of their own generation, and buy and sell power exclusively through the spot markets of the California Power Exchange (PX). This prevented the utilities from hedging their risks by developing a portfolio of short-term and long-term energy products. Second, the State mandated a retail rate reduction and freeze, eliminating any incentives for demand reduction, discouraging entry by competitors for retail sales and, more recently, threatening the financial health of the three utilities by delaying or denying their recovery of billions of dollars in costs incurred to provide service to retail customers.

However, California's situation does not demonstrate the failure of electricity competition. To the contrary, it demonstrates the need to embrace competition fully, instead of tentatively. Other states, such as Pennsylvania, have been successful in implementing electricity competition. California needs to move forward on the competitive path it has chosen, allow new generation and transmission to be sited and built, and allow its citizens to benefit from the lower rates, higher reliability, and wider variety of service options that a truly competitive marketplace can provide.

B. Other Factors

Until last year, California's spot market prices were substantially lower than even California's mandated rate freeze level. This allowed the California utilities to pay down billions of dollars of costs incurred during cost-of-service regulation. However, several events resulted in higher spot electricity prices beginning last summer. Those events included one of the hottest summers and driest years in history, as well as several years of unexpectedly strong load growth. Other factors influencing prices recently include:

- Unusually cold temperatures earlier this winter in the West and Northwest;
- California generation was unavailable to supply normal winter exports to the Northwest;
- very little generation was added in the West, particularly in Washington, Oregon and California, during the last decade;
- environmental restrictions limited the full use of power resources in the region;
- scheduled and unscheduled outages, particularly at old and inefficient generating units, removed large amounts of capacity from service; and

- natural gas prices increased significantly, due to higher commodity prices, increased gas demand, low storage, and constraints on the delivery system.

Taken together, these factors demonstrate that the present problems in electricity markets are not just "California" problems. Normal export and import patterns throughout the West have been disrupted. Reserve margins throughout the West are shrinking. Already this winter, when the demand for electricity is relatively low, Stage 3 emergencies in California have become commonplace.

III. The Commission Has Taken Important Steps to Help

These problems require bold and decisive action. Both the federal government and state governments have critical roles to play in promoting additional energy supply and deliverability and decreasing demand. Through its authority to set rates for transmission and wholesale power and to regulate interstate natural gas pipelines and non-federal hydroelectric facilities in interstate commerce, the Commission can take a range of measures to promote a better balance of supply and demand, but its jurisdiction is limited. The Commission can set pricing policies which encourage entry, but it is state regulators that have siting authority for electric generation and transmission facilities, as well as authority over local distribution facilities (both for electricity and natural gas). These authorities can go a long way in improving the grid for both electricity and natural gas. More importantly, state regulators have the most significant authorities to encourage demand reduction measures, which can greatly mitigate the energy problems in California and the West.

A. Promoting Market Stability

In an order issued on December 15, 2000, the Commission adopted a series of remedial measures designed to stabilize wholesale electricity markets in California and to correct wholesale market dysfunctions. The Commission recognized that the primary flaw in the California market design was the requirement for the three California utilities to buy and sell solely in spot markets. The Commission concluded that the foremost remedy was to end this requirement and allow the utilities, first, to use their own remaining generation resources to meet demands and, second, to meet much of their remaining needs for power through forward contract purchases. This measure freed up 25,000 MW of generation that the utilities owned or controlled, which could be used directly to serve their load without having to sell it into the Power Exchange and buy it back at a much higher spot price. Our action returned to California the ability to regulate over one-half of its peak load requirements.

B. The Commission's Latest Efforts

Last Friday, the Commission took further steps to mitigate prices in California, specifically the prices charged in California's spot markets during Stage 3 emergencies in January of this year. After examining prices charged in these periods, the Commission identified many transactions that warranted further investigation. The Commission required these sellers to either refund certain amounts (or offset these amounts against amounts owed to them) or provide additional information justifying their prices. Specifically, the Commission required refunds or offsets of approximately $69 million dollars, or all prices charged during Stage 3 hours in excess of $273 per megawatthour. This analysis seeks to use a proxy price based on the market clearing price that would have occurred had the sellers bid their variable costs into a competitive single price auction.

The ISO and the California Electricity Oversight Board ("California parties") asked the Commission to require larger refunds. However, the Commission explained the difference between their approach and the Commission's. First, they included over $170 million for refunds from non-public utility sellers, such as the Los Angeles Department of Water and Power. The Commission has no authority to order any refunds from these sellers. Second, they included refunds for sales during all hours of January; the Commission limited its approach to Stage 3 Emergency hours, when the supply/demand imbalance is most severe and sellers know their power is most needed. Third, they used a pay-as-bid approach instead of the Commission's proxy market clearing price approach and they used bids only slightly above (10 percent) variable costs. Finally, they included refunds for December 2000; the Commission will address the December transactions in a separate order. In sum, the Commission's approach fully protects consumers from possible exercises of market power during emergency conditions while still providing clear price signals encouraging sorely needed new generation and load reductions.

Also last Friday, the Commission's staff issued a proposal on how the Commission should monitor and mitigate prices in California's wholesale spot power markets. This proposal is based on monitoring and mitigating prices on a before-the-fact basis, instead of through after-the-fact refunds. Comments on the staff's proposal are due on March 22nd.

After receiving and considering public comment, the Commission intends to implement appropriate changes to its current market monitoring and mitigation requirements by May 1, 2001.

IV. Other Ways in Which the Commission Can Help

Since the supply of electricity in California and the West this summer may be significantly less than the demand, we must do more than just hope for mild weather and rain. We must focus on measures that will promote electricity supply and deliverability and decrease demand. Such measures are critical if we are to meet our goal of ensuring an adequate supply of power for consumers at reasonable prices.

An important element in this effort is upgrading energy deliverability – through enhancements to electrical transmission and natural gas pipeline systems. Without these upgrades, constraints and bottlenecks increasingly will block energy supplies from reaching load.

With these concerns in mind, the Commission must remove obstacles to increased generation and supply in Western markets. Similarly, the Commission must identify and develop strong incentives to build necessary electric and natural gas infrastructure. The Commission, by itself, cannot solve all of the energy problems facing California and the West. But, we may be able to offer valuable short-term contributions to help ease the current shortages, as well as medium- and long-term contributions to help avert future recurrences. My fellow Commissioners and I have discussed such steps and we hope to implement a wide range of such steps in the near future.

V. Price Caps Would Make Things Worse

Some advocate price caps or cost-based limitations as a temporary way to protect consumers until longer-term remedies alleviate the supply/demand imbalance. The issue of price caps in the West has been raised on rehearing of the Commission's order of December 15, 2000, and, accordingly, is pending before the Commission. For this reason, I cannot debate the specific merits of price caps for California or the West. However, I will reiterate briefly the views I have stated publicly on this issue.

As a general matter, I do not believe that price caps promote long-term consumer welfare. Price caps will not increase energy supply and deliverability or decrease demand. Instead, price caps will deter supply and discourage conservation. At this critical time, legislators and regulators need to do everything they can to promote supply and conservation, not discourage them.

My belief is based on experience, not just economic theory. The summer of 1998 demonstrates my point. Then, wholesale electricity prices in the Midwest spiked up significantly. The Commission resisted pleas for immediate constraining action, such as price caps. Subsequently, suppliers responded to the market-driven price signals, and today the Midwest is not experiencing supply deficiencies.

In short, price caps can have long-term harmful effects because they do not provide appropriate price signals and may exacerbate supply deficiencies. Supply and demand cannot balance in the long-term if prices are capped.

With respect to the bills that are the subject of today's hearing, I do not believe Congress should mandate specific ratemaking standards for the Commission to carry out. The Commission already has sufficient authority to implement price caps if the Commission determined they were needed.

S.26 and S.287 would require "cost-of-service based rates," while S.80 would require "cost-based rates." Either of these "cost" standards likely would require on-the-record, trial-type procedures which would be lengthy, costly and contentious. Litigating such a rate case for one seller requires a significant commitment of resources. Concurrently litigating such cases for scores of sellers in the West would be overwhelming both for the Commission and the industry. Moreover, neither buyers nor sellers would be sure of the prices until the conclusion of this litigation. This delay in price certainty would be unfair to customers and discourage new investments by suppliers.

Many leaders share these views. In a letter to the Secretary of Energy, dated February 6, 2001, eight Western governors expressed their opposition to regional price caps. They explained that "[t]hese caps will serve as a severe disincentive to those entities considering the construction of new electric generation, at precisely the time all of us – and particularly California – are in need of added plant construction."

In the face of the current challenges, we all must have an open mind to any proposals that may mitigate the energy problems in the West. I remain unconvinced that price caps will help solve the problems and I do not believe they are in the long-term interest of consumers.

VI. Conclusion

The Commission remains willing to work in a cooperative and constructive manner with other federal and state agencies. The Commission will continue to take steps that, consistent with its authority, can help to ease the present energy situation without jeopardizing longer-term supply solutions. As long as we keep moving toward competitive and regional markets, I am confident that the present energy problems, while serious, can be solved. I am also confident that market-based solutions offer the most efficient way to move beyond the problems confronting California and the West. Thank you.

TECHNICAL ANALYSIS BY COMMISSION STAFF

S. 26

* Overview - The bill would require the Secretary of Energy to impose in any region of the United States an interim regional price limitation or cost-of-service based rate for jurisdictional sales whenever:

    (1) the Commission finds that the otherwise applicable rate is unjust and unreasonable or the Secretary finds that the otherwise applicable rate exceeds marginal cost significantly; and

    (2) the Secretary finds that: (a) the otherwise applicable rate threatens public health and safety or the economy of any State or region and (b) the Commission has failed to act to improve the situation.

* Interim regional price limitation - is defined as reflecting load differentiated demand and including a region-wide wholesale price limit for the Western Systems Coordinating Council (WSCC) region. However, the bill specifies no substantive standard for determining the level of the price limitation. For example, the bill does not state whether the price limitation should reflect supplier costs, historical rates or any other factor. The lack of specificity could be addressed by adding the same standard contained in the Federal Power Act, that rates must be just and reasonable.

* Load differentiated - is defined as "the difference between price limitations by season, time of day, and other relevant usage patterns." The bill assumes that prices can be differentiated among time periods in a predictable way. Recent experience in California is to the contrary, with off-peak prices often higher than peak prices.

* Cost-of-service based rate - Determining such rates for all jurisdictional sellers in the WSCC may exceed available resources at the Department of Energy and take years to resolve; even at the Commission the task would take years, well beyond the time needed to increase supply significantly in the West. Until such rates are determined, neither sellers nor buyers will have rate certainty. This lack of rate certainty would be unfair to consumers and discourage new investments by suppliers. Also, a "cost-of-service based rate" (as opposed to a "cost-based rate") may preclude area-wide or average rates, options otherwise allowed under the FPA. The bill does not make clear whether these rates should be determined as systemwide rates or facility-specific rates.

* Jurisdictional sales - The bill applies only to sales at wholesale in interstate commerce subject to Commission jurisdiction under FPA Part II. The bill would not

apply to many other wholesale sales in California made by, e.g., governmental entities. Regulating prices in only one part of a market is unlikely to be fully effective and instead may serve only to shift resources into the other parts of the market.

* Authority to Impose Limitations - The bill requires the Secretary to impose price caps "in any region of the United States. . . ." As noted above, however, the bill also defines an "interim regional price limitation" as limited to the WSCC, in conflict with the broader scope of the "any region" language.

Also, the bill does not specify whether the determinations required by this section must be done by rule or adjudication, or whether affected persons will have any due process rights, e.g., notice, an opportunity to be heard, or judicial review.

One of the determinations required by this section is that the existing rate "threatens public health and safety or the economy of any State or region. . . " Another determination is that the "Commission has otherwise failed to act to improve the situation. . . " However, the bill specifies no standards for making these subjective findings.

The bill also is unclear on the procedures for implementing the Secretary's rates. For example, the bill does not state whether the new rates must be filed with FERC. The bill also does not make clear how the Secretary's actions interact with any ongoing processes at FERC, e.g., if the Secretary implements new rates in place of rates currently being investigated by FERC or pending on appeal. The bill could be construed as allowing the Secretary's unilateral action to nullify any ongoing administrative or judicial processes and any due process rights being met through those processes.

The bill states that the "Secretary may exercise any authority vested in the Commission under the Federal Power Act for the fixing and enforcing of rates, charges, and classifications that are just and reasonable. . . ." This language suggests, but does not make clear, that the Secretary's orders are subject to rehearing under the FPA and reviewable in appellate court.

* Duration of rates - The bill provides that the rates set by the Secretary "shall remain in effect until such time as the market reflects just and reasonable rates, as determined by the Secretary." This provision appears to preclude filings by public utilities to change rates under Section 205 or by their customers to change rates under Section 206, eliminating the parties' fundamental rights under the FPA.

* Opt out - The bill allows the Governor of any State to opt out of the regional price limitation or cost-based rates for purposes of sales to purchasers in that State. Under

this provision, each state may have an incentive to opt out in order to attract scarce supplies. The result may be a bidding war.

Also, this section of the bill does not specify the rates that take effect when a state opts out. Arguably, the opting out should reinstate the rates authorized by FERC immediately before the Secretary's imposition of superseding rates, but the bill is unclear. In addition, the bill specifies no procedures for a state to notify FERC when it opts out.

S. 80

* Overview - The bill would require the Commission to order refunds of any jurisdictional market-based rates found unjust and reasonable, if the rates were paid up to two years before the Federal Register notice. Also, the bill would require the Commission to impose cost-based rates for jurisdictional sales made in the WSCC after June 1, 2000, if the Commission finds (on its own motion or upon petition of a Governor in the WSCC) that the rates for such sales are unjust and unreasonable.

* Time allowed for action on a Governor's petition for cost-based rates - The bill requires the Commission to act within 30 days after receiving such a petition. This period may be too short to allow parties an adequate opportunity to comment or for the Commission to conduct a hearing, if one is necessary.

* Maximum prices - must be limited to "the seller's costs, including a return of and on invested capital. . ." The bill does not specify the applicable time period for measuring costs, or whether a seller's costs include opportunity costs. This provision appears to preclude area-wide or average rates, options otherwise allowed under the FPA. Also, the bill does not make clear whether these rates should be determined as systemwide rates or facility-specific rates. Determining such rates for all jurisdictional sellers in a WSCC State would take years, well beyond the time needed to increase supply significantly in the West. Until such rates are determined, neither sellers nor buyers will have rate certainty.

* Jurisdictional sales - The bill applies only to rates for a transmission or sale of electric energy subject to Commission jurisdiction. The bill would not apply to many other wholesale sales in California made by, e.g., governmental entities. Regulating prices in only one part of a market is unlikely to be fully effective and instead may serve only to shift resources into the other parts of the market.

* Penalties - The bill would require a penalty of three times the amount of any violation. This penalty would apply to any "person who violates any requirement of

this section." The intent appears to be to penalize sellers who charge more than the cost-based rates specified under this section, but the penalty provision arguably could extend to any seller found to have charged more than a just and reasonable rate, even before the Commission has imposed cost-based rates under this section. If so, this section would be a strong disincentive for sellers to participate in this market. At a minimum, the risk of future penalties would create substantial uncertainty for sellers.

S. 287

* Overview - The bill would require the Commission, within 60 days after enactment of the bill, to impose cost-of-service based rates for jurisdictional sales in the "western energy market." A "cost-of-service based rate" is defined as equal to "(A) all the variable and fixed costs for producing the electric energy; and (B) a reasonable return on invested capital."

* Western energy market - is defined as the States of Arizona, California, Colorado, Idaho, Montana, Nevada, New Mexico, Oregon, Utah, Washington, and Wyoming.

* Cost-of-service based rate - This provision appears to preclude area-wide or average rates, options otherwise allowed under the FPA. Also, the bill does not make clear whether these rates should be determined as systemwide rates or facility-specific rates. The bill requires FERC to set such rates within 60 days after enactment of the bill, an unrealistic deadline given the administrative processes necessary to set cost-of-service based rates while allowing due process for affected parties. Sellers' costs may differ substantially, depending on the type of generation unit, the price of natural gas and NOx emission allowances and other factors.

* Jurisdictional sales - The bill applies only to sales by public utilities, defined as a person that owns or operates a facility "subject to the jurisdiction of the Commission under the Federal Power Act." While the more plausible interpretation of this provision is that it applies only to entities subject to the Commission's section 205-206 jurisdiction, it could be interpreted as applying not only to these entities but also to entities that, although exempt from section 205-206 jurisdiction, are subject to jurisdiction under other FPA provisions. The scope of the bill should be clarified.

* Duration - The cost-of-service based rates must remain in effect "until such time as the market for electric energy in the western energy market reflects just and reasonable rates, as determined by the Commission." This language is unclear but the intent appears to be that the Commission could replace the cost-of-service based

rates upon finding that the proposed superseding rates would be just and reasonable. This provision should be clarified.

Sen. Smith's Proposed Amendment to S. 287

* Overview - The amendment would preclude S. 287's cost-of-service based rates from applying to wholesale sales for delivery in a State that does not allow recovery of FERC-approved rates or a public utility's costs or that has barred a public utility from paying for power purchased in the Western energy market.

The amendment also would prevent anyone in the Executive branch and any court from ordering a sale of electric energy or natural gas "unless there is a guarantee that, as determined by the Commission, is sufficient to ensure that the seller will be paid the full purchase price when due."

The amendment would allow a State public utility commission to prohibit a public utility "in the State" from making a sale of electric energy if the "public utility is not meeting the demand for electric energy in the service area of the public utility."

Finally, the amendment would repeal S. 287 two years after the bill's enactment. The repeal would apply to any cost-of-service based rates imposed pursuant to S. 287.

* "In the State" - As noted above, the amendment would allow a State public utility commission to prohibit a public utility "in the State" from making a sale of electric energy if the "public utility is not meeting the demand for electric energy in the service area of the public utility." The amendment does not define the phrase "in the State." This phrase could mean, e.g., a utility is doing business in the state, has physical facilities in the state or is incorporated in the state. The amendment's intent should be clarified.